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Squeaky Hinges: Widening the Door to Canadian Cross-border Investment

By Matt Krzepkowski and Jack Mintz

- For the period 2001-2007, Canada ranked only 25th among 98 countries in its openness to world markets as measured by cross-border investment flows as a percentage of GDP. For inbound investment flows alone, it ranked 47th.
- In failing to be more open, Canada loses out on managerial and technological expertise, increased human capital and productivity, and higher wages.
- Canada should look to dismantle barriers to both inbound and outbound foreign investment to increase business exposure to global competition.

While foreign direct investment has been a controversial issue in Canada, the reality is that Canada's openness to world capital flows, both inbound and outbound, is not impressive by world standards. This lack-lustre performance is problematic considering the net benefits derived from greater access to global capital and technology markets.

Emotions on the issue run high. Sharp increases in the number and size of mergers and acquisitions by foreign investors, like those involving Falconbridge, Inco, Alcan and Cognos, have raised fears of Canadian industry being hollowed-out by foreign corporations operating in their own interests and against those of Canadians. These fears, in 2007, led to calls for then-Industry-Minister Jim Prentice to consider blocking more cross-border acquisitions, to which he responded by launching a Competition Policy Review Panel.

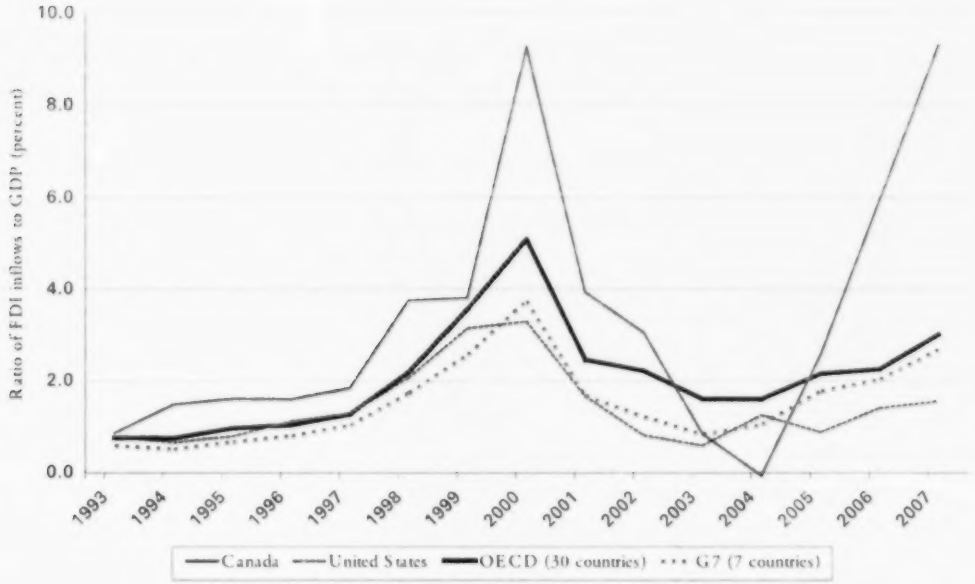
What are the smart policy responses for Canada? To consider that question, this *e-brief* examines the broader context of investment flows, which suggests Canada should, in fact, be concerned about low levels of both inbound and outbound investment.

While inbound investment into Canada sharply picked up in the first half of 2007 (exceeding outbound investment flows), this matched worldwide trends. Measured by the International Monetary Fund, net inflows into Canada have only deviated considerably from the trends of 30 OECD countries twice (Figure 1):[1] once during the technology boom of 1999-2000 and again more recently as commodity prices boomed. Those are the only times that Canada has been a net capital importer since 1995.

More broadly, over the period 2001-2007, Canada ranked only 25th among 98 countries in its openness to world capital markets as measured by the sum of inbound and outbound foreign direct investment in relation to its size as an economy. Countries like the United Kingdom, Spain and France have been more open to international capital markets than has Canada.

1 Direct investment abroad (net outflows) and foreign direct investment (net inflows) in the reporting economy represent the change in the assets owned by investors in a country as cross-border investments. Direct investment includes equity capital, reinvested earnings, other capital and financial derivatives associated with various inter-company transactions between affiliated enterprises that are at least 10 percent owned by the parent. Excluded are flows of direct investment capital for exceptional financing such as debt-for-equity swaps. See International Monetary Fund, *International Financial Statistics* (August 2008) and the International Monetary Fund's *Balance of Payments Manual* (Fifth edition 1993).

Figure 1. Ratio of FDI Inflows to GDP for Selected Countries and Country Groups



Sources: FDI flows: International Monetary Fund, International Financial Statistics, August 2008; GDP: United Nations Statistics Division, United Nations Common Database, May 2008.

Too much FDI does not seem to be Canada's problem, especially now when credit markets are making it more difficult for businesses to acquire funds for investment.

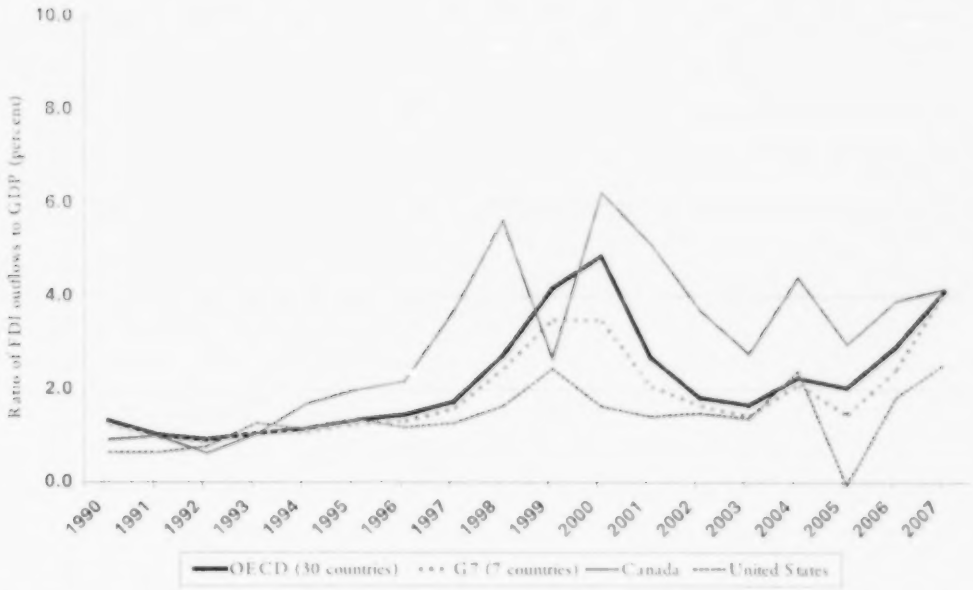
Why Inbound and Outbound Investment Flows Are Important

The economic cost to Canada in failing to be more open to world economic capital flows is significant: we lose out on managerial and technological expertise imported here, as well as the income that comes from Canadian businesses succeeding abroad.

Allowing international investments into Canada also has a positive effect on the Canadian economy. Foreign companies bring in technological advancements from international R&D markets, increasing human capital and productivity, and leading to higher wages. These technologies and innovations may also spill over to domestic firms, increasing their productivity. Foreign-controlled companies in Canada are often more productive than Canadian-controlled companies (see Guillemette and Mintz 2004, and Statistics Canada 2008), and foreign-controlled subsidiaries are more active in trade than domestic firms, with higher imports and exports relative to sales. True, Canadians worry that foreign companies are less sensitive to Canadian concerns, contributing less to communities, for example, but little evidence exists to support such claims.

The overall advantages of open trade in capital markets should push Canada to consider lowering, rather than raising, barriers to integration with the rest of the world. Business tax reductions and regulatory relaxation in economies such as Luxembourg, Hong Kong, the Netherlands, and the United Kingdom have increased FDI inflows and outflows, leading to higher economic growth rates (Li and Liu 2005).

Figure 2. Ratio of FDI Outflows to GDP for Selected Countries and Country Groups



Sources: FDI flows: International Monetary Fund, International Financial Statistics, August 2008; GDP: United Nations Statistics Division, United Nations Common Database, May 2008.

Canada's Exposure to World Capital Markets Not Extraordinary

Despite a recent influx of investment in 2006 and 2007, Canada still ranks 47th out of 98 industrialized and developing countries when measuring FDI inflows as a share of GDP, with the average over the 2001-2007 period being 3.7 percent of GDP (Table 1). While Canada's average FDI inflow has increased from our 1994-2000 average of 3.4 percent, other countries have made bigger gains, and Canada has fallen from 37th rank. On the positive side, Canada has shown more strength in FDI net outflows, and from 2001 to 2007 was consistently above the OECD average (Figure 2). Canada's average over the period 2001-2007 was 3.9 percent, a slight increase from the 3.7 percent in the 1994-2000 period. Canada's rank held steady at 13th among 98 major countries.

For this study, we calculate the sum of inflows and outflows as a share of GDP to measure how 'open' a country is to international capital flows. Under this specification, Canada ranks 25th out of 98 major countries based on results for 2001-2007. Despite Canada outperforming many nations in 2007, its rank has still fallen seven spots since the 1994-2000 period.

It appears that the events in 2006 and 2007 were more of a spike than the sign of a new trend, with the inflow of capital as well as the size and number of transactions falling dramatically after a peak in the second quarter of 2007. During the second quarter, a record $166 billion in transactions took place, while in the third quarter this value dropped to $91 billion (with the acquisition of Alcan Inc. by Rio Tinto Group accounting for $40 billion).[2] This decline has carried into 2008, with total transactions amounting to $24.3 billion in the first quarter, and only seven transactions over $1 billion, compared to 13 in the first quarter of 2007. Since the potential benefits of foreign investment in Canada have not diminished, Canada should ensure that it is a more attractive destination.

2 All merger and acquisition statistics from Crosbie & Company Inc., various years.

Table 1: Country Ranking by the Ratio of Foreign Direct Investment Net Inflows and Net Outflows as a Percentage of GDP (Averaged over 2001–2007 for 98 Countries)

Rank by FDI Sum	Country or Area Name	FDI Inflows (% of GDP)	Rank by Inflows	FDI Outflows (% of GDP)	Rank by Outflows	Sum of Inflows and Outflows (% of GDP)	Change in Rank
1	Luxembourg[a]	334.7	1	374.9	1	709.6	0
2	Iceland	10.8	7	26.2	2	36.9	60
3	China, Hong Kong Special Administrative Region[b]	17.7	2	16.5	3	34.2	0
4	Singapore	14.9	4	7.9	7	22.8	0
5	Belgium[a]	11.3	5	10.5	4	21.9	-4
6	Hungary	10.8	6	7.7	8	18.5	6
7	Netherlands	6.8	20	9.4	6	16.3	0
8	Bulgaria	15.0	3	0.3	55	15.3	35
9	Switzerland	4.2	35	9.8	5	14.0	4
10	Ireland	5.3	27	7.1	9	12.4	-1
11	Kazakhstan	10.0	10	0.3	54	10.3	11
12	United Kingdom	5.1	30	5.1	13	10.2	-6
13	Georgia	10.1	8	0.0	92	10.1	15
14	Lesotho	10.0	9	0.0	90	10.0	-7
15	Jordan	9.7	11	0.2	64	9.9	44
16	Sweden	4.2	37	5.5	11	9.7	-8
17	Spain	3.6	48	6.0	10	9.6	6
18	France	3.7	46	5.3	12	9.0	1
19	Chile	6.8	19	2.0	25	8.9	-4
20	Jamaica	7.4	14	1.0	33	8.4	10
21	Israel	4.5	33	3.6	16	8.1	29
22	Croatia	7.0	17	1.0	35	7.9	19
23	Slovakia	7.6	13	0.3	56	7.9	34
24	Trinidad and Tobago	8.2	12	-0.3	97	7.9	-15
25	Canada	3.7	47	3.9	14	7.5	-7
26	Czech Republic	7.0	18	0.5	47	7.4	1
27	Congo	7.2	16	0.1	69	7.3	-10
28	Belize	7.2	15	0.1	84	7.3	12
29	Aruba	6.5	21	0.1	74	6.6	-3
30	Republic of Moldova	6.4	22	0.1	80	6.5	13
31	Austria	2.9	60	3.5	17	6.5	21
32	Cambodia	6.3	23	0.2	65	6.5	-7
33	Romania	6.2	24	0.1	82	6.3	28
34	Portugal	3.3	52	3.0	19	6.3	2
35	Botswana	4.5	32	1.7	27	6.3	41
36	Malaysia	3.3	50	2.8	20	6.1	-17
37	Latvia	5.4	26	0.7	44	6.1	-8
38	Finland	3.2	55	2.7	21	5.8	-25
39	Cape Verde	5.7	25	0.1	79	5.8	-5
40	Colombia	4.4	34	1.0	31	5.5	11
41	Fiji	5.2	28	0.1	66	5.4	-14
42	Denmark	2.2	66	3.1	18	5.3	-30
43	Ukraine	5.1	29	0.1	67	5.3	38
44	Norway	1.3	81	3.8	15	5.1	-20
45	Slovenia	3.0	57	1.9	26	4.9	39
46	Russian Federation	2.6	62	2.3	22	4.9	30
47	Poland	4.0	40	0.8	38	4.8	-2
48	Lithuania	4.0	39	0.7	43	4.7	-1
49	The former Yugoslav Republic of Macedonia	4.6	31	0.0	89	4.6	20
50	Kyrgyzstan	3.8	44	0.8	39	4.6	-14
51	Thailand	4.1	38	0.4	52	4.5	-1

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Rank by FDI Sum	Country or Area Name	FDI Inflows (% of GDP)	Rank by Inflows	FDI Outflows (% of GDP)	Rank by Outflows	Sum of Inflows and Outflows (% of GDP)	Change in Rank
52	Tunisia	4.2	36	0.2	61	4.4	12
53	China	3.9	41	0.4	50	4.3	-20
54	Costa Rica	3.9	42	0.3	58	4.1	-5
55	Uruguay	3.8	43	0.1	76	3.9	29
56	Brazil	3.0	56	0.9	36	3.9	-2
57	Mali	3.7	45	0.1	71	3.9	17
58	Mexico	3.2	54	0.6	46	3.8	-13
59	Australia	2.1	68	1.7	29	3.8	-1
60	Germany	1.4	78	2.2	23	3.7	-28
61	Peru	3.4	49	0.1	70	3.6	-25
62	Italy	1.4	79	2.1	24	3.5	21
63	Bolivia	3.2	53	0.0	87	3.3	-46
64	El Salvador	3.0	58	0.1	68	3.1	-9
65	Egypt	2.9	59	0.1	78	3.0	16
66	United States	1.3	82	1.7	28	2.9	-21
67	Togo	3.3	51	-0.4	98	2.9	2
68	Turkey	2.6	64	0.3	59	2.8	24
69	New Zealand	2.8	61	0.1	83	2.8	-34
70	Morocco	2.6	63	0.2	60	2.8	24
71	Netherlands Antilles	2.0	69	0.7	42	2.7	20
72	Argentina	2.1	67	0.4	51	2.5	-31
73	Venezuela	1.4	80	1.0	32	2.4	-33
74	Cameroon	2.3	65	0.0	86	2.4	12
75	Philippines	1.6	75	0.6	45	2.2	-14
76	South Africa	1.9	71	0.3	57	2.2	-9
77	Libyan Arab Jamahiriya	1.7	73	0.5	48	2.2	20
78	Solomon Islands	1.8	72	0.2	63	2.0	-23
79	Pakistan	1.9	70	0.1	85	2.0	6
80	Indonesia	0.7	93	1.2	30	1.9	7
81	Greece	1.0	91	0.7	41	1.6	-11
82	Mauritius	1.2	85	0.3	53	1.6	-21
83	India	1.1	88	0.4	49	1.6	6
84	Korea, Republic of	0.6	96	0.8	40	1.4	-12
85	Belarus	1.6	74	-0.2	93	1.4	-7
86	Sri Lanka	1.3	83	0.1	73	1.4	-7
87	Swaziland	1.5	76	-0.3	94	1.3	-65
88	Benin	1.3	84	0.0	88	1.3	-15
89	Gabon	1.5	77	-0.3	96	1.2	10
90	Paraguay	1.1	87	0.1	77	1.2	-27
91	Senegal	1.0	90	0.2	62	1.2	-20
92	Barbados	1.0	89	0.1	72	1.2	-4
93	Japan	0.2	97	1.0	34	1.1	-1
94	Niger	0.9	92	0.1	75	0.9	-1
95	Namibia	1.2	86	-0.3	95	0.9	-35
96	Kuwait	0.0	98	0.8	37	0.9	0
97	Kenya	0.7	95	0.1	81	0.7	-4
98	Bangladesh	0.7	94	0.0	91	0.7	-4

Sources of data:

FDI flows: International Monetary Fund, International Financial Statistics, August 2008.

GDP: United Nations Statistics Division, United Nations Common Database, May 2008.

Notes:

a. The averages for Luxembourg and Belgium are over the period of 2002–2007. Prior to 2002, the combined FDI inflows and outflows were reported for these countries. The Belgium-Luxembourg combined averages over 2001–2007 for FDI inflows, outflows, and sum of inflows and outflows are equal to 38.2%, 41.8%, and 38.2% of GDP, respectively.

b. Hong Kong is China's Special Administrative Region.

Policy Changes are Necessary

The recent report by the Competition Policy Review Panel (2008) made a number of important recommendations to improve Canada's competitiveness. Overall, it supported the view that Canada should look to dismantle barriers to both inbound and outbound foreign direct investment to increase business exposure to global competition. Policy innovations would include removing limitations on ownership in transportation, communications and finance. Less government ownership of business enterprises would also reduce barriers to investment in these sectors. Tax policies, such as high withholding taxes on dividend payments to non-residents negotiated under bilateral treaties, make Canada less open to outbound or inbound FDI, and these could be lowered or eliminated.

The guiding principle behind these policy recommendations is straightforward – Canada should treat domestic businesses the same, regardless of the sector in which they operate, and treat all businesses operating in Canada identically, irrespective of ownership. Canada's domestic tax and competition laws should be applied fairly to both domestic and foreign corporations to ensure unbiased competition and equitable taxation, enabling the economy to reap the full benefits of access to international markets.

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